

I. TAX EXEMPT ORGANIZATIONS AND WORLD WIDE WEB FUNDRAISING AND ADVERTISING ON THE INTERNET

by
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Part 1 - World Wide Web Fundraising

1. Introduction

The purpose of this article is to discuss solicitation of contributions, advertising, and merchandising techniques under the Internet's World Wide Web (WWW) protocol by tax-exempt organizations. Please see Topic C of the 1999 CPE text and Topic A of the 1996 text for a general description of how the Internet operates.

As has been stated repeatedly in our series of articles on exempt organizations and computers, the use of the Internet to accomplish a particular task does not change the way the tax laws apply to that task. Advertising is still advertising and fundraising is still fundraising. However, the nature of the Internet does change the way in which these tasks are accomplished. The purpose of this article is to explain those changes and their practical consequences, and to remind both Service employees and the interested public how the tax laws apply to specific areas.

This article will include a brief discussion of such practical topics as how to create a web page and related security issues and will discuss in greater depth current Internet fundraising practices and their tax implications for charities and for donors, and advertising and merchandising techniques and their treatment under the unrelated trade or business provisions of the Code.

2. How the Web Works

A. Ease of Creating Web Pages

Web pages are created using formatting codes which instruct web browsers how to display the text and graphic images within the codes, and which create links between different parts of a page or between different pages. These formatting codes, called "tags" are collectively known as HyperText Markup Language, or HTML. Any file intended to be displayed by a web browser must therefore have a filename that ends in ".htm" or ".html". This file extension tells the browser to look for and interpret the codes. Below are some simple examples. While the formatting codes are shown here in capital letters for ease of viewing, that is not a requirement of HTML.

All tags must be enclosed in angle brackets. All tags have a beginning tag and a corresponding end tag, although use of the end tag is not required for all tags. All web pages must begin with <HTML> and end with </HTML>, and must contain a <TITLE> section and a <BODY> section. Here is a very simple web page that took only a few minutes to write:

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<HTML>
<HEAD>
<TITLE>HTML Example</TITLE>
</HEAD><BODY>
<H1 ALIGN=CENTER>Save the Internet Foundation</H1>
<P>Please send money at once to our nonprofit organization to save the Internet. Our address
is: Save the Internet Foundation, 123 Main Street, Anytown, VA.</P>
</BODY>
</HTML>
```

Some web pages are very elaborate, and it may be difficult to believe that such simple codes can create these complex pages. While it's true that HTML can be much more complex than the simple example shown above, it's also true that learning HTML is unnecessary. Nor is it always necessary to hire a professional, although many businesses and exempt organizations do. Some word processing programs will create HTML files. The user places text and images as desired on the page, and the word processing program adds the necessary HTML codes. Even more powerful are programs designed specifically to create web pages, such as Visual Page. At least one major Internet Service Provider (ISP) provides free software for members to use to create web pages.

There's not much point in creating a web page without a place to put it where it is accessible to the public. However, low-cost (or even free) space is readily available. Many ISPs include a certain amount of space on their server for member web pages as part of their regular membership package. Others charge a small additional fee. There are also hosting services that will provide users with space for a small fee or with free space for web pages in exchange for the right to show advertisements to visitors.

The purpose of this technical information is to demonstrate how quickly and easily any organization or individual can establish an Internet presence. Setting up a direct mail or telephone fundraising campaign requires a substantial amount of time and money. Furthermore, it is unlikely that a professional fundraiser would enter into such a contract without proof of the charity's exempt status. Setting up a web page to solicit contributions takes little time, a trivial amount of money and no proof of exempt status. A web page can be uploaded quickly, and taken down or moved just as quickly.

An April 8, 1999 article in the *Washington Post* demonstrated just how easy and effective a fraudulent web page can be. Someone created a website that looked and behaved very much like that of a well-known financial information wire service and uploaded it to one of the web hosting services referred to above. The site reported, falsely, that another company was acquiring a California technology firm. This false report was then spread through another service's finance message boards by referring people to the false website. By the time the fraudulent website was identified and removed, the California firm's stock was up 31%. At the end of the day, hours after correct information had been released; the stock was still up 10% over the previous day.

B. Links and How They Work

What makes the Web unique is the way in which information is chained together by links. A link will usually appear underlined and in a distinctive color on the page. Links may also consist of graphic images. If clicked on, a link will take the user to another place in the same document, another page in the same website or to another site on another computer somewhere else on the Internet. For example, a page discussing Roman civilization and describing ancient buildings might contain links to visitors' guide that has pictures of the buildings referred to. The HTML codes underlying the link contain the URL (uniform resource locator), or address, of the link, such as *http://www.xyz.com*. Often the URL will tell something about the nature of the site. In this case, *.com* indicates a commercial site. Other common suffixes include:

.org	non-profit organization
.edu	educational institution
.gov	government agency
.net	old designation, could be anything
.mil	military

However, since an exempt organization's website can appear on a commercial hosting site, and will thus have an address part of which ends in *.com*, this is not an infallible guide.

C. Security Issues

In the HTML example above, contributors were asked to send money to a post office box. However, that requires a significant effort by the viewer to send funds. How much easier it would be if the entire transaction could be conducted online. The contributor can respond immediately and easily by providing a credit card number and the recipient has nearly immediate access to the money. This raises certain security issues, however. Many people will not provide credit card information via the Internet because they are concerned that the information will not be properly safeguarded. Certainly sending such information via e-mail is not entirely safe. There is no guarantee that the information will not be intercepted and

misused. Of course, the interception and misuse of credit card information outside of the Internet is a well-known problem. These problems do not prevent people from giving their account numbers over the phone or handing their credit cards to a waiter.

Credit card issuers have an even greater interest in the security of credit card information. If a credit card number is stolen and misused, by federal law, the liability of the individual cardholder is limited to a maximum of \$50. There is no such limit on the issuer's liability.

Some security is provided through the use of secure servers, in which the credit card number is encrypted. The use of *https* instead of *http* in the URL indicates a secure server. Depending on the brand of browser software being used, an icon of a padlock or a key will also appear on the screen.

D. Merchant Accounts and Factoring

In order for a charity or a business to accept payment via credit card, it must have a “merchant account” with a credit card issuer. To get such an account, a charity, like any business, must submit an application and undergo a credit check and site inspection. There are also various applications and processing fees required. Many charities, especially small or new organizations, are unwilling or unable to incur these expenses and resort to credit card factoring. Factoring, also called credit card laundering is described by the Better Business Bureau as follows:

A Company that does not have a credit card merchant account with a bank or credit card company recruits another company to process its credit card transactions through its own merchant account. When the processing merchant receives payment for the credit card charges, it turns the money over to the company without an account, but it keeps a previously agreed to percentage or other fee.

Credit card factoring is a violation of the merchant agreement with the credit card issuer. In one state (Florida) it has been explicitly made a criminal act, and in other states it may be prosecuted under various fraud statutes. Civil liability is also likely.

3. Tax Treatment of Contributions

This section provides a brief discussion of the tax laws pertaining to both charitable and non-charitable contributions, including references to prior CPE articles where appropriate. This article deals only with cash contributions, since noncash contributions generally are not made directly over the Internet.

A. Charitable Contributions

IRC 170(a) allows the deduction of charitable contributions as defined in IRC 170(c). The latter section defines charitable contribution to include a contribution or gift to or for the use of a corporation organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual. While a determination of exempt status under IRC 501(c)(3) is not a requirement, it is a way a contributor can know, before making a contribution, that it will in fact be deductible. Contributions to foreign organizations are generally *not* deductible.

A concern with respect to online contributions is determining (before the contribution is made) whether or not the organization is an eligible recipient. One way to do this is by looking for the organization in Publication 78, available at many libraries and at: www.irs.ustreas.gov/prod/bus_info/eo/eosearch.htm.

Even a contribution to an organization exempt under IRC 501(c)(3) may not be deductible if the contribution is earmarked for a specific individual or for an organization which is not itself entitled to receive charitable contributions. For a detailed discussion of the issues involved in earmarking contributions for individuals, see Topic E of the 1996 CPE text.

In general, individuals claiming deductions for charitable contributions need to be able to document the amount of the contribution and the charitable status of the recipient. The Omnibus Budget Reconciliation Act of 1993 created additional substantiation requirements. These requirements are discussed in detail in Topic E of the 1995 CPE text and Topic G of the 1997 text

Publication 1771 provides additional information about these requirements. No deduction will be allowed for any charitable contribution of \$250 or more unless the donor has contemporaneous written substantiation from the charity. In cases where the charity has provided goods or services to the donor in exchange for making the contribution, this contemporaneous written acknowledgement must include a good faith estimate of the value of such goods or services. Thus, taxpayers may no longer rely solely on a cancelled check to substantiate a cash contribution of \$250 or more.

There is no prescribed format for the written acknowledgement. For example, letters, postcards or computer-generated forms may be acceptable. The acknowledgement does not have to include the donor's social security or tax identification number. It must, however, provide sufficient information to substantiate the amount of the deductible contribution. The responsibility for obtaining this substantiation lies with the donor, who must request it from the charity. The charity is not required to record or report this information to the IRS on behalf of donors. Some sites that solicit donations provide acknowledgements via e-mail. Would such an acknowledgement, standing alone, satisfy the requirements? The answer is uncertain.

In addition, under IRC 6115, a charitable organization must provide a written disclosure statement to donors who make a payment, described as a "quid pro quo contribution," in excess of \$75. Note that this requirement is based on the amount of the payment, not the amount that is considered a deductible contribution. This requirement is separate from the written substantiation required for deductibility purposes as discussed in the preceding paragraph. A quid pro quo contribution is a payment made partly as a contribution and partly for goods or services provided to the donor by the charity. The required written disclosure statement must:

- (1) inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of any money (and the value of any property other than money) contributed by the donor over the value of goods or services provided by the charity, and
- (2) provide the donor with a good-faith estimate of the value of the goods or services that the donor received.

Penalties are imposed on charities that do not meet the disclosure requirements with respect to quid pro quo contributions. The penalty is \$10 per contribution, with a maximum of \$5,000 per fundraising event or mailing.

Contributions of items that are not cash or a readily marketable security require a qualified written appraisal if they are worth more than \$5,000. See, Reg. 170A-13(c)(1).

B. Non-charitable Contributions

Many organizations described in IRC 501(c) or (d) and exempt under IRC 501(a) that are not charitable in nature solicit contributions from the public to fund their activities. Many such organizations implied that contributions to them were deductible, or at least refrained from explaining that such contributions were not deductible. In response to these abuses, Congress passed IRC 6113 in 1987.

IRC 6113 requires organizations that are ineligible to receive tax deductible charitable contributions to disclose the nondeductibility of contributions during fundraising solicitations. Organizations whose annual gross receipts do not normally exceed \$100,000 are excepted from this requirement.

Notice 88-120, 1988-2 C.B. 454, provides additional guidance, including safe harbors, regarding these requirements. The Notice provides explicit safe harbors for various types of solicitations, including print media (mail, printed advertisements in newspapers or magazines), telephone, television, and radio solicitation. Naturally, there are no specific references to computer-based methods of communication, such as e-mail or web pages.

However, it is not difficult to adapt the requirements of the Notice to computer-based communications. In general, there is no reason to treat e-mail solicitation any differently from direct mail solicitation. Web fundraising is also most similar to print media, since unlike telephone, television, and radio, the viewer generally controls what he or she looks at and for how long. Therefore, web-based fundraising by organizations subject to the requirements of section 6113 should be in compliance if it meets the following requirements:

1. The solicitation includes one of the statements listed in the Notice;
2. The statement is in at least the same type size as the primary message, and is readily visible against the background of the page;
3. The statement appears on the same page as, and in close proximity to, the actual request for funds; and
4. The statement is either the first sentence in a paragraph or itself constitutes a paragraph.

Requirement #3 requires some additional explanation. To meet this requirement, the viewer must be able to see the statement without following a link. The statement must appear *before* the "submit" or other button to transmit information to the soliciting organization. This is to ensure the viewer has an opportunity to see the statement before making a contribution.

Section 6113 does not apply to solicitations by letter or telephone call if the letter or call is not part of a coordinated fundraising campaign soliciting more than ten persons during the calendar year. This exception clearly does not apply to web page solicitations, but might apply to e-mail solicitations.

Section 6710 provides penalties for failure to comply with the requirements of section 6113, unless the failure is due to reasonable cause. The penalty is \$1000 for each day on which a failure occurs, up to a maximum annual penalty of \$10,000. In cases where the failure to make the required disclosure is due to intentional disregard of the law, the \$10,000 limitation does not apply. More severe penalties based on the greater of 50% of the aggregate cost of the solicitations or \$1000 per day are applicable.

How do these penalty provisions apply to Internet fundraising? With respect to e-mail solicitations, IRC 6710(d)(2) provides that failure to meet IRC 6113 requirements in mail solicitations is treated as occurring when the solicitation was mailed. Notice 88-120 provides an example, and states:

If an organization mails 500 noncomplying solicitations on March 30 and 50 noncomplying solicitations on April 5, the penalty would be \$2000.

Web page solicitations are more problematical. IRC 6710(d)(3) provides that written or printed solicitations (other than mail) shall be treated as occurring when the solicitation was distributed. With a magazine or newspaper, it's easy to determine when it was distributed, since the distribution is a discrete event. With a web page, it is possible to argue that it's distributed when it is uploaded to a server and thus becomes available to the public. The alternative would be to say that it is distributed whenever it is accessed. The latter option would, however, result in extremely large penalties and would be difficult to enforce.

4. Current Fundraising Practices Using the Internet

A. Charity's Own Web Page

Many tax-exempt organizations now have a web page that describes their purpose, discusses their activities, provides lists of upcoming events, lists local affiliates, provides contact information, and more. It's only a short step from there to recruiting members and soliciting donations online. Combining these features can be very effective. For example, disaster relief organizations can show pictures of a disaster and request contributions. Of course, the same thing can be done with a brochure, but that is far more expensive and takes much longer.

Most commentators on the subject of online fundraising do not believe that charities in general will raise significant amounts of new money using these methods. Many seem to believe that previous contributors may donate online for the sake of its novelty. In general, the advice provided to charities is to include a fundraising component on web pages, but not to expect too much from it.

Such contributions made directly to a charity raise no novel tax issues. However, due to the nature of the Web, as described earlier in this article, contributors need to be certain who they are giving to and what the tax status of the recipient is. For the charities themselves, a greater concern may be the applicability of state and local laws requiring registration before soliciting contributions. There is some concern that states and local governments will argue that if any resident of their jurisdiction can access a website and thus see a solicitation, the charity must register. One author has estimated that compliance with all state and local solicitation laws could cost a charity as much as \$150,000 each year.

Possibly more productive may be online sales, either directly, through a "storefront," or through a contractual arrangement with a retailer. Many nonprofit websites now offer a link to an online bookseller. Such arrangements permit visitors to order books on the topic of interest, with the charity receiving a percentage of the sale price. See the other section of this article for more information on this topic.

B. Third Party Sites

The security problems discussed above and the expense of setting up a merchant account to enable a charity to accept credit card donations have made many organizations reluctant to solicit donations on the Internet. There are, however, several websites that have been established to facilitate online donations to many unrelated organizations. Most of these are provided by organizations that are not themselves tax-exempt. This section describes how these entities operate and the tax implications for charities and donors. Interestingly, most of these sites claim that they are not soliciting donations. Such statements are apparently intended to avoid the state and local registration requirements imposed on professional fundraisers. It is not clear what legal effect, if any, such disavowals may have.

One such website, which we'll call "*donate.com*", describes itself as an international secure online donation service for nonprofit organizations. It is operated by a for-profit Internet consulting firm. Visitors to the site select the desired recipient from an alphabetical list. A brief mission statement for each is available, as well as a link to the organization's own website (if it has one). After selecting a charity, the donor provides the usual credit card information. An e-mail acknowledgment of the gift is sent by "*donate.com*" to the donor immediately. Monthly, donations will be sent to the designated charities, along with a list of

donors. “*Donate.com*” retains 15% of each donation as an administrative fee.

In our example, “*donate.com*” emphasizes that it does not represent, endorse, or promote participating charities. It is not a registered fundraiser. It states that “most” donations are tax deductible. Anyone can submit the name of an organization to be listed, although donations to a particular charity will not be enabled until the charity has signed an enrollment form. It is not clear to what extent, if any, *donate.com* verifies the tax status of participating organizations, although the website implies that, at least for U.S. charities, a copy of a 501(c)(3) determination letter is requested. However, many of the organizations listed could not be located in Pub. 78 or any of the publicly available references referred to earlier.

As mentioned above, *donate.com* describes itself as an international service. There are several foreign organizations listed on the website, but nothing to indicate that contributions to such organizations are not deductible for U.S. tax purposes.

Assuming for the moment that the ultimate recipient is a domestic 501(c)(3) organization, are contributions made via *donate.com* tax deductible? Without seeing a copy of the agreement between *donate.com* and participating charities (assuming that such agreements exist), a definitive answer may not be possible.

Rev. Rul. 85-184, 1985-2 C.B. 8, holds that utility customers, who pay additional amounts on their utility bills to a utility company acting as agent for a charitable organization that assists individuals with emergency energy needs, are entitled to a charitable deduction for the additional amount in the year paid. In this case, the charity entered into an agreement with the utility company that designated the utility as the charity's agent to collect contributions on its behalf. Amounts collected by the utility were transferred to the charity on a weekly basis and were at all times segregated from the utility's own funds. The utility did not use any of the funds collected to cover expenses it incurred in connection with the program. Under these circumstances, the utility is acting as the charity's collection agent in receiving certain amounts in excess of monthly fees billed to its customers that are earmarked for use by the charity. Further, the utility exercises no dominion and control over such amounts. Therefore, delivery of such amounts to the utility constitutes delivery to the charity for purposes of IRC 170.

In PLR 9335022, a similar conclusion was reached in a case in which the funds were initially deposited in the utility's own bank account, but were transferred on a weekly basis to the charitable recipient, in this case, a state agency described in IRC 170(c)(1). Again, the Service concluded that the utility received the funds solely as an agent for the charitable recipient and the funds were not within the utility's dominion and control even though they resided briefly in the utility's bank account.

In the case of *donate.com*, the facts are somewhat different. First, *donate.com* collects a fee for its services, which reduces the amount of the donation paid to the recipient charity. Second, funds are held by *donate.com* for a month (not a week) before being turned over to the recipient charity. Third, we don't know the terms of the agreement between *donate.com* and participating charities, so we don't know if *donate.com* can be considered as an agent for the participating charities. Under these facts, we don't have enough information to determine whether contributions are deductible or not. There are also audit policy issues involved that determine whether or not deductions would be allowed.

Other similar sites present fewer concerns. One, while also operated by a for-profit firm, states that it is privately funded and does not retain any portion of the amounts donated. Furthermore, its list of charities is much shorter and all appear to be domestic 501(c)(3) organizations. Again, without viewing the contract between the operators of the website and the exempt organizations, it is impossible to determine with certainty whether the website is acting as the agent for the organizations. Other commentators have noted that all of these sites may present credit card factoring issues, which, while not a problem with respect to deductibility, should be of some concern to the participating charities. Commentators have also pointed out the possibility of running afoul of state and local registration laws, since few if any of the third party sites have registered as professional fundraisers.

C. Electronic Scrip

As discussed elsewhere in this article, there are any number of arrangements between charities and particular retailers in which the charity encourages purchases and receives money in return. A new variation on this process is "electronic scrip."

Sales of scrip as a fundraising device are discussed in detail in Topic T of this text. Briefly, charities buy scrip from participating retailers at a discount, typically 5%, then resell it at face value. The purchasers then use the scrip like money. The charity keeps the 5% difference.

At least one company now offers "electronic scrip." A participating charity gets its supporters to register their credit card numbers with the program and pay a small annual fee. Every time a supporter uses a registered credit card to make a purchase from a participating

retailer, a donation is credited to the charity. In no case does this result in a charitable contribution on the part of the purchaser.

D. E-mail Solicitations

E-mail solicitations present, in general, the same legal issues as any direct mail solicitation. However, unlike direct mail, e-mail solicitation requires little up-front investment. The only thing a solicitor need purchase is a file containing e-mail addresses. The Better Business Bureau has reported an instance in which an individual was requesting, via e-mail, \$1 contributions to assist tornado victims. Funds were to be sent to a post-office box, with any checks made out to cash. There have been reports of a similar solicitation, purportedly on behalf of an orphanage. While there are no novel tax issues raised, this is another example of the need to use common sense and good judgment in making contributions to any organization.

5. References

How Can We Use the Internet for Fundraising?

<http://www.nonprofit-info.org/misc/9810273m.html>

Current Controversies: Out-of-State Solicitation and Regulation

http://www.muridae.com/nporegulation/foreign_solicitation.html

Part 2 - World Wide Web Advertising and Merchandising Techniques

1. Overview of Web Advertising and Merchandising Techniques

A. Purpose

The new "Mall of the World" may well be the World Wide Web and exempt organizations of all types and sizes have demonstrated that they are eager to take advantage of this new entree to potential donors, members, and supporters. Maintaining a web presence enables exempt organizations to access millions of persons around the world 24 hours a day, 7 days a week. New material, including advertising, can be added to an organization's website, virtually on demand.

The Service has yet to consider many of the questions raised by web advertising, merchandising, and publishing, however, it is reasonable to assume that as the Service position develops it will remain consistent with our position with respect to advertising and merchandising and publishing in the off-line world. We would welcome the opportunity to consider applications or proposed transactions would enable us to provide appropriate assistance in developing such cases and providing additional guidance. As part of the FY1999 Business Plan the Internal Revenue Service indicated that it is committed to providing formal guidance to the exempt organizations community. At this writing, an Announcement is to be prepared for publication in the Internal Revenue Bulletin relating to the appropriate treatment of website materials. Accordingly, while this article does not constitute formal guidance it is intended to point out certain practices that have developed as exempt organizations have entered cyberspace and how these practices may impact on the tax liability of exempt organizations.

B. Terminology

To comprehend web advertising one must be familiar with some of the basic terminology of the web advertising industry.

Hit: A term referring to the number of files downloaded from a website.

Page View or Impressions: A term referring to the number of visitors who view a page or banner ad.

Banner Ad: A name for a graphic advertisement, usually a moving image, measured in pixels.

Click or Click-through: A click of the mouse on a banner ad/graphic/or HyperText link

which transports the website visitor to another website or location within the site.

C. Methods of Selling Web Advertising and Soliciting Sponsorships

The advertising rates that an exempt organization can charge will vary considerably based on its area of concern, the quality of its web site and the user traffic it generates. Generally, paid advertising is solicited using one of the following methods.

D. Flat Rate Fees

Some organizations charge a flat fee in advance for displaying a banner, graphic, or statement of sponsorship such as "This month this website is brought to you by X. Visit them at WWW.goodcorp.com." Visitors can click through the banner, corporate logo or other mechanism to an advertiser's site. Generally, exempt organizations tend to favor the less obtrusive sponsorship statements rather than the banner advertisement that is perceived as more appropriate to commercial sites and potentially more offensive to potential donors. Also, as discussed below, a moving banner is probably more likely to be classified as an advertisement subject to unrelated business income tax rather than a permissible statement of corporate sponsorship. The positive side of charging a flat-rate fee is that the organization is better able to predict its advertising/sponsorship income.

E. Pay-Per-View

Pay-per-view advertisements result in the accrual of a small credit to the host organization each time a site visitor views the advertisement. The host organization earns credits when someone actually views the advertisement. Software within the website maintains a verifiable, auditable count. Unless a website has a lot of traffic this is not usually a great source of revenue for the typical exempt organization. This type of advertising is, of course, more popular with advertisers since it is more results oriented.

F. Click-through Charges

The click-through-charge method of pricing advertisements is related to the pay-per-view mechanism, but instead of paying for the number of page views, the advertiser only pays for the number of people who click-through the advertisement, i.e. affirmatively select and visit the advertisers own site. Likewise, this type of advertising generally does not generate much revenue unless the site is heavily used and the advertisements change frequently since return visitors to the site are unlikely to click-through to the same advertiser on a repeated basis. However, the advantage of this adopting this type of pricing policy is that it is easier to attract advertisers since the mechanism is clearly results oriented.

G. Link/Banner Exchanges

Many organization websites include a page of links to related, affiliated, or similar recommended sites. Other organizations, often those having a similar area of concern, such as environmental organizations, operating as a free-coop, exchange banners or links. Still others use the services of a service provider to facilitate banner exchanges with appropriate organizations. These exchanges may require the organization to carry other advertising as well as part of the provider agreement.

It is unclear whether the Service will treat link or banner exchanges as similar to a mailing list exchange or whether an organization that participates in such a program may incur liability for unrelated business income.

In analyzing these exchange mechanisms, one must look to the purpose of the link/banner exchange. One must determine whether the link exchange is an exchange of advertising or rather, merely an attempt to refer the site visitor to additional information in furtherance of the organization's exempt purposes and activities.

H. Pro-Bono Advertising

The Ad Council develops advertisements for exempt organizations and offers them to corporations and search engines free of charge.

2. Advertising v. Corporate Sponsorship

The differences between an advertisement and corporate sponsorship is further complicated in the Internet environment. For example, it is not uncommon for an organization to seek corporate support to underwrite the production of all or part of an exempt organization's website. These relationships may be short-term or continue on a long-term basis. The financial support may be acknowledged through display of a corporate logo, notation of the sponsor's web address and or 800 number, a moving banner, or HyperText link.

The line between a permissible acknowledgment and a taxable advertisement is at the heart of all corporate sponsorship cases. See the discussion of this issue and the legislative history of section 513(i) in the 1999 CPE Text at page 282. See particularly the discussion of TAM 9805001, in which the Service considered whether certain displays of the logo, name and products of a sponsoring dog food company at an annual kennel club show constitute advertising or corporate sponsorship.

A. What is Advertising?

Generally, advertising includes messages containing qualitative or comparative language, price information, or other indications of savings or value, endorsements and inducements to purchase, sell, or use the products or services. Proposed Reg. 1.513-4(b) provides in part that advertising means any message or other programming material which is broadcast or others i.e. transmitted, published, displayed or distributed in exchange for any remuneration, and which promotes or markets any company, service, facility or product.

B. Corporate Sponsorship Online

Generally, exempt organizations prefer to view payments as corporate sponsorship rather than advertising income, which is more likely to be subject to unrelated business income tax. The use of promotional logos or slogans that are an established part of a sponsor's identity is not, by itself advertising. In addition, display or sale of a sponsor's product by the organization at a sponsored event has been held to constitute a mere use or acknowledgment rather than advertising.

The legislative history of section 513(i) suggests that a payment is not a qualified sponsorship payment if the amount is contingent by contract or otherwise upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to an activity. On the other hand, the fact that a sponsorship payment is contingent on an event actually taking place or being broadcast, does not, in itself, effect whether a payment qualifies.

C. Advertising and Corporate Sponsorship in the Internet Environment

These issues raise special concerns in the Internet environment. Commentators in the exempt organizations community have raised the question of whether the use of a HyperText link in an acknowledgment will change the character of a payment from corporate sponsorship to advertising income subject to the unrelated business income tax. Many argue that the payment should retain its character as a mere acknowledgment since the website visitor must take an affirmative action to reach the donor's website.

The 1999 CPE Text discussion of Internet Service Providers, at page 64, provides support for the position that a link will retain the passive character associated with corporate sponsorship while a moving banner is more likely to be considered to be advertising. If, on the other hand a payment, or any part thereof, is determined to be advertising, one must consider the fair market value of the advertising component.

Certainly, in determining fair market value of web advertising there are many variables. However, in developing cases where fair market value is at issue, it would be useful to gather information with respect to numbers of page views and click throughs to the advertiser as well

as any other indicia of the amount of traffic on the site should be taken into account.

D. Income Tax Implications of the Characterization of Website Materials

There has been some discussion in the tax-exempt circles with regard to how to characterize website materials. Most of the materials made available on exempt organization websites are clearly prepared in a manner that is distinguishable from the methodology used in the preparation of periodicals. While there is no precise definition of the term periodical section 513(i) provides that the term qualified sponsorship payments does not include payments that entitle the sponsors to acknowledgments in "regularly scheduled and printed material" published by or on behalf of the exempt organization.

Accordingly, in considering how to treat potential income from website materials for income tax purposes the Service will look closely at the methodology used in the preparation of the website materials. The Service will be unwilling to allow the exempt organization to take advantage of the specialized rules available to compute unrelated business income from periodical advertising income unless the exempt organization can clearly establish that the on-line materials are prepared and distributed in substantially the same manner as a traditional periodical.

This is not to say that there can not be an on-line publication that can be treated as a periodical. While some periodicals have on-line editions and some print publications are reproduced on-line, sometimes on a subscription basis, or in a members-only access portion of a website, such materials should be and generally are, sufficiently segregated from the other traditional website materials so that the methodology employed in the production and distribution methods are clearly ascertainable and the periodical income and costs can be independently and appropriately determined. Presumably such genuine periodicals would have an editorial staff, marketing program, and budget independent of the organization's webmaster.

E. Virtual Trade Show or Potential Unrelated Trade or Business

Some trade associations are trying to replicate the trade show in the virtual reality format. The organizations may receive income from individual "virtual exhibitors" as well as income from "corporate sponsors" of the event. In considering how the Service may treat virtual trade show income it is useful to see how the Internal Revenue Code and regulations have addressed these issues in the traditional context.

Section 513(d) of the Code and section 1.513-3(b) of the Income Tax Regulations provide that certain traditional convention and trade show activities carried on by a qualifying organization (i.e., one described in section 501(c)(3), 501(c)(4), 501(c)(5) or 501(c)(6)) in connection with a qualified convention or trade show will not be treated as unrelated trade or

business and income from such activities will not be subject to the tax imposed by section 511. The qualifying organization must regularly conduct, as one of its substantial exempt purposes, a qualified convention or trade show activity.

A qualified convention or trade show activity is any activity of a kind traditionally carried on by a qualifying organization in conjunction with an international, national state, regional or local convention or annual meeting or show if:

- a. One of the purposes of the organization in sponsoring the activity is promoting and stimulating interest in, and demand for, the products and services of that industry, or educating the persons in attendance regarding new products and services or new rules and regulations affecting the industry, and
- b. The show must be designed to achieve its purpose through the character of the exhibits and the extent of the industry products that are displayed.

The rental of trade show display space to exhibitors (including exhibitors who are suppliers to qualifying organization members) at a qualified convention or trade show will not be considered an unrelated trade or business even though the exhibitors who rent the space are permitted to sell or solicit orders. For this purpose, a supplier's exhibit is one in which the exhibitor displays goods or services that are supplied to, rather than by, members of the qualifying organization in the conduct of these members' own trades or businesses.

The safe harbor exclusion of section 513(i) with respect to qualified sponsorship payments, however, does not apply to payments made in connection with "qualified convention or trade show activities"

The Service has yet to rule on unrelated business tax implications of virtual trade shows. Whether a qualifying organization which engages in the conduct of "virtual trade shows" will be accorded similar treatment will most likely depend in large part on whether the qualifying organization is able to demonstrate that its exhibits or displays are substantially similar to those traditionally carried on at a trade show.

In developing such cases the Service would certainly look to all the surrounding facts and circumstances. Some so-called virtual trade shows merely consist of a listing of HyperText links to industry suppliers' websites for which remuneration is received by the website host trade association. Others have displays including educational information related to issues of interest to industry members. Virtual trade shows are sometimes timed to coincide with the sponsoring organization's annual meeting or regular trade show in order to increase participation by industry members who are unable to attend the actual events. It is highly questionable whether income from a year round virtual trade show would be accorded

exclusion from unrelated business income tax. Clearly, section 513 of the Code and the regulations thereunder suggest that the character of the exhibits is significant. In addition, an organization that seeks corporate sponsorship for its web site and anticipates conducting virtual trade shows should consider the implications with respect to the 513(i) safe harbor in its web design and operations.

3. Merchandising Online

A. Online Storefronts

Online storefronts complete with virtual shopping carts are becoming increasingly popular on exempt organization web-sites. Various search engines offer free virtual storefronts. In addition, readily available software programs make it relatively simple for an exempt organization to establish its own storefront.

While the Service has yet to address any cases specifically addressing on-line merchandising issues it is useful to review how the Service has traditionally addressed sales activities of exempt organizations. The treatment of museum gift shop sales was discussed in the 1997 CPE Text at 257 and the 1999 CPE Text at 286. See particularly the discussion of TAM 97-20002 (11/26/96). In applying the "primary purpose" test to such sales the Service looks to the nature, scope and motivation for the particular sales activities.

Accordingly, in addressing Internet merchandising cases it is reasonable to use the same analysis that the Service would apply in sales made through stores, catalogues or other traditional vehicles. Merchandise will have to be evaluated on an item-by-item basis to determine whether the sales activity furthers the accomplishment of the association's exempt purposes or is simply a way to increase revenues.

B. On-Line Auction Activities

Yesterday's thrift shop has become today's on-line auction. These auctions enable many exempt organizations to turn material donations into cash. While some organizations conduct their own auctions many exempt organizations turn to outside service providers. Some on-line auction websites provide services for exempt organizations only while some websites and search engines operate auctions for individuals and for profit businesses as well. Operating the auction under the auspices of an outside auction service provider may provide a larger auction audience than might be available if the auction were conducted on the charity's own website and enable the organization to avoid some credit card fraud problems but entering into an agreement with an outside service provider might have tax implications.

In analyzing such cases one must consider how much control the charity will continue to

exercise over the marketing and conduct of the auction. Unless the event is sufficiently segregated from other, particularly, non-charitable auction activities, and the exempt organization retains primary responsibility for publicity and marketing the Service may be more likely to view income from such auction activities as income from classified advertising rather than as income derived from the conduct of a fundraising event. In addition, the relationship with the individual service provider should be closely scrutinized, particularly in view of the fact that the on-line organization is working in a multi-state arena and regulatory arena. In this regard, these service providers are essentially professional fundraisers and their functions and fees should be scrutinized using traditional inurement and private benefit principles.

C. Online Charity Malls

A number of Internet sites permit on-line member shoppers to designate a favorite charity and shop at affiliated vendors through links on the website. For each purchase the member/shopper makes, the vendor agrees to remit an agreed upon percentage of the purchase price to the designated charity through the charity mall operator. Vendors enter into individual agreements with the mall operators and the amount of rebate to the mall operator may vary anywhere from 1.5% to 12.5%. A few of the charity mall operators represent that they use volunteer labor and pass on 100% of the funds raised to the designated charities. Some malls solicit paid advertisements as well with varying terms. Others indicate that they may retain a "small "percentage of the proceeds for site maintenance and development. The mall operator credits the charity with the contribution upon receipt of the rebate from the vendor, often a month after the purchase. See the first part of this article for a description of the problems inherent in determining the extent to which amounts paid may be treated as deductible by donors.

In developing applications for exemption or ruling requests involving such organizations a number of issues must be addressed. Although many of the existing organizations are operated as non-profit (but not exempt) organizations some members of the exempt organizations community have expressed an interest in developing an exempt charity mall. The decision in American Bar Endowment v. Commissioner, 177 U.S.105, Commissioner , 477. U.S. 105, 106 S. Ct. 2426 (1986) may be useful in addressing these cases. One must consider whether it is the shopper/member or the mall operator who retains any right to direct the rebate to the charitable organization or receive a refund. In addition, since the marketing and operation of the virtual mall is a trade or business ordinarily carried on for profit it is questionable whether the organization can establish that it meets the operational requirements of section 501(c)(3). Certainly, the terms of the agreement between the vendor and the mall operator will be critical in determining whether the shopper can claim a deduction for the rebate/contribution. In addition, the agreement with the mall operator is important in helping to determine the level of involvement of the charity itself in the operation of the mall. Finally,

a more fundamental concern about these virtual charity mall operations is that the beneficiary organizations do not appear to have any agreement with the virtual mall operators and do not appear to be entitled to any record of member designations or transactions. In addition, the exempt organization has little recourse if it finds its name used in association with such mall operators, who may or may not prove reputable.

D. Individual Merchant Affiliate Programs

Affiliate and other co-venture programs continue to grow in popularity, both on and off-line, with numerous variations. Probably the most ubiquitous programs on the Internet today involve co-ventures with large on-line booksellers, although art galleries, toy merchants and event credit report providers have such programs. These programs are available to and popular with large national organizations as well as small booster clubs. Organizations are offered the option of making particular book recommendations that may be "displayed" or listed on the organization website or simply use a logo or HyperText link to the bookseller. Some links simply state that "We receive a royalty on ...books purchased through X bookseller." The exempt organization earns a percentage of sales of recommended materials as well as a lesser commission on other purchases sold through the referring link. The exempt organization receives a weekly or other periodic report detailing link activity.

The Service has not yet considered issues regarding the tax treatment of such income but there has been much litigation in the area of affinity credit card programs in the last several years that may impact on the tax treatment of such income.

At the time of this writing, the Service and the Tax Court continue to take differing positions respect to affinity credit cards (and mailing lists). The Service continues to view the marketing of a credit card by an exempt organization as involving services typically provided by a commercial company, while the Tax Court has taken the view that amounts derived from participation in the affinity program constitute royalty income that is excluded from the computation of unrelated business income tax. See 1999 CPE Text at page 277.

A distinct advantage that these programs have over the virtual mall type operations from the point of view of the charity is that the exempt organization itself enters into an agreement with the merchant and is provided an activity report in order to ensure that it credited with the appropriate royalty. On the other hand, while it is questionable whether the virtual mall member would be able to claim a deduction for his designated "donation" it appears clear that the shopper in the smaller scale affiliate program would not be entitled to an IRC 170(c)(2) deduction.

E. Potential Problems Involving Membership, Professional and Trade Associations

Many of these organizations have comprehensive web-sites with materials for the general public as well as materials that are restricted to members only. Many of these member only sections provide access to research services, continuing education opportunities, employment listings, membership directories, links to various organization benefit programs, legislative alerts, publications, etc. Organizations and web designers must be aware that the traditional rules with respect to prohibitions on providing particular services, treatment of advertising income, sales activity, as well as lobbying restrictions still apply to website activities.

4. Conclusion

The IRS 1999 Business plan contemplates issuance of a request for comments on the application of current rules on the Internet activities of exempt organizations, in particular with respect to the treatment of unrelated business taxable income, lobbying expenditures and political intervention. This shows a clear recognition by the Service of the importance of the potential role of the Internet in the future of exempt organizations. It is hoped that all members of the exempt organizations will be involved in the development of new policies which will build upon principles developed over time and adapt to allow exempt organizations to take advantage of the technological innovations of the new millennium.